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Before the FEDERAL COMMUNICATIONS COMMISSION Washington, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION OFFICE OF THE SECRETARY

In the Matter of

The Allowance for Funds Used During Construction (AFUDC) Rate Properly Charged by Dominant Carriers For Ratemaking and Other Purposes



REPLY OF U S WEST COMMUNICATIONS, INC.

U S WEST Communications, Inc. ("USWC"), through counsel and pursuant to Federal Communications Commission ("Commission") Rule 1.405(b), hereby reply to the comments filed by the United States Telephone Association ("USTA"), BellSouth Corporation ("BellSouth"), Southwestern Bell Telephone Company ("SWB"), the NYNEX Telephone Companies ("NYNEX") and the Opposition of MCI Telecommunications Corporation ("MCI") in response to the above-captioned petition for rulemaking.

With the exception of MCI, all parties support

Ameritech's request that the Commission initiate a rulemaking to

¹Effective January 1, 1991, Northwestern Bell Telephone
Company and Pacific Northwest Bell Telephone Company were merged
into The Mountain States Telephone and Telegraph Company ("MTN,
NWB and PNB"). Effective January 2, 1991, MTN's name was changed
to U S WEST Communications, Inc. Prior to the merger and name
change, MTN, NWB and PNB had been doing business as U S WEST
Communications. See The Mountain States Telephone and Telegraph
Company, Northwestern Bell Telephone Company, and Pacific
Northwest Bell Telephone Company, 5 FCC Rcd. 1982 (1990).

²47 C.F.R. § 1.405(b). <u>See Public Notice</u> dated February 15, 1991, Mimeo No. 11820.

³The Ameritech Operating Companies ("Ameritech") filed the rulemaking petition ("Petition") herein.

modify its rules to provide that the rate applicable to Allowance for Funds Used During Construction ("AFUDC") needs to be set at the current overall cost of capital. If adopted, Ameritech's proposed rule would compensate investors fully for financing long-term construction projects. For the reasons stated below, USWC supports the Ameritech petition. Additionally, USWC asks that the Commission examine closely the feasibility of adopting the Generally Accepted Accounting Principles ("GAAP") to AFUDC.

I. THE COMMISSION SHOULD INITIATE A RULEMAKING TO REEXAMINE THE APPROPRIATENESS OF THE CURRENTLY AUTHORIZED RATE APPLICABLE TO AFUDC

Like other local exchange carriers ("LEC"), USWC also uses internally-generated funds, <u>i.e.</u>, a combination of debt and equity (depreciation and net income), to finance its long-term

inequitable. USWC agrees with the majority of commenters that the Commission should no longer mechanically apply this rule. The time is ripe to initiate a rulemaking proceeding to revisit the AFUDC.

The Commission's basic rationale for using the prime rate found its origin in American Telephone and Telegraph Company, The Associated Bell System Companies, Charges for Interstate Telephone Service, Docket No. 19129, Phase II ("Docket No. 19129"), where it required the American Telephone and Telegraph Company ("AT&T") to accrue interest on its long-term construction projects based on prime rate. In 1978, when there was one unified Bell System, this decision might have had some merit because it was relatively easy for AT&T to borrow shortterm debt from financial institutions at prime rate to finance its construction projects. As BellSouth pointed out, many of those facts and circumstances have changed in the ensuing years, e.g., the post-divestiture environment, and the fact that Western Electric tax credits are no longer available to the LECs. 10 More significant, however, the regulatory and financial environment has also changed since divestiture. LECs are now operating in a

Moreover, it appears that the Commission is applying contradictory cost recovery rules in Part 65. In authorizing the LECs' Part 65 rate of return, all debt (both long-term and short-term) is used. In the rules for AFUDC, only short-term debt is allowed.

^{&#}x27;See Illinois Bell Telephone Co. v. F.C.C., 911 F.2d 776,
783 (D.C. Cir. 1990)("Illinois Bell").

¹⁰BellSouth at 1-2.

competitive arena. Excluding the equity funding component of AFUDC negatively impacts a carrier's cash flow which, in turn, affects its bond ratings and the equity investors' perception of risk. 11

In any event, setting the AFUDC at prime rate is inconsistent with how the LECs actually fund their construction projects. It is also inconsistent with the Commission's express policy to encourage carriers to reinvest their earnings in their regulated business. 12 The Commission should initiate a rulemaking to establish a new record regarding the LECs' own methods of financing their long-term constructions. If evidence provides a rational basis for change, the Commission should adopt a new AFUDC rate for the LECs. 13

II. MCI'S OPPOSITIONS HAVE NO MERIT AND SHOULD BE DENIED

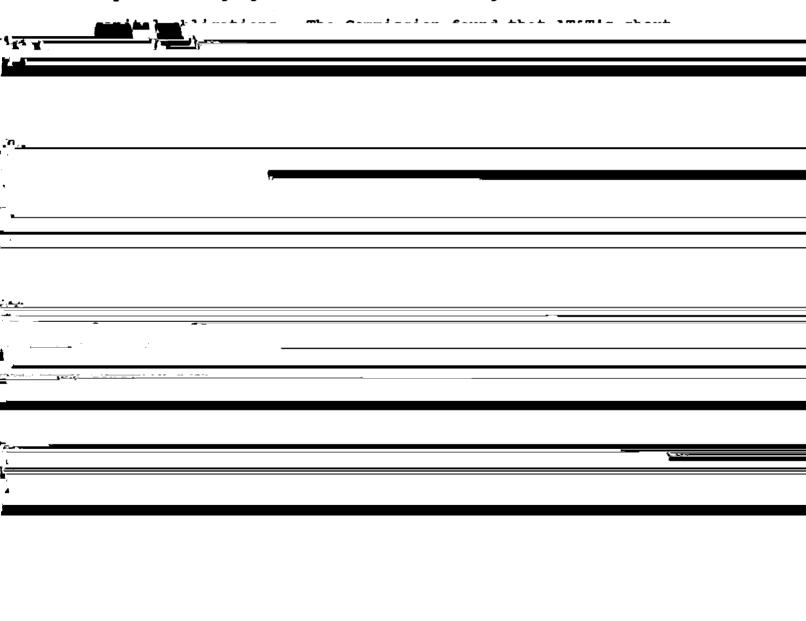
MCI asserts that in Docket No. 19129, Phase II, the Commission merely found that AT&T had the ability to obtain short-term funding at the prime rate and that its decision was

¹¹Business risk and competition play an integral part in any determination of LEC cost of capital. Bond rating agencies have explicitly recognized the increase in LEC business risk since 1986. Recent actions by rating agencies reflect investor perceptions of increased LEC business risk. <u>See</u> Standard & Poor Credit Week, August 3, 1989, at 4-7; Duff & Phelps Inc., Credit Decisions, Mar. 27, 1989, Vol. 6, No. 12, at 1.

¹² See Petition at 6. See also USTA, SWB and BellSouth.

¹³As Ameritech points out, the alternative is to include Account 2004 (PUC-long term) in the rate base. <u>See</u> Petition at n.11.

not based upon AT&T's actual capital. 14 The negative inference is, of course, that the Commission should not even reference the LECs' capital in reconsidering the AFUDC because it did not do so in Docket No. 19129. 15 Contrary to MCI's assertion, evidence shows that the Commission did consider AT&T's overall cost of capital to segregate its construction budget from its total



prior decision in <u>Communications Satellite Corporation</u>, ¹⁸ which was pending on remand at that time. In <u>Comsat</u>, the Commission had erroneously assumed that carriers could finance all long-term construction projects by short-term borrowing and that the needed capital could be obtained at the prime rate. It totally ignored the correct assumption that a mix of capital was used for long-term construction and that it should bear a close relationship to Comsat's actual working capital. On appeal, the Court held that the Commission's justification for requiring Comsat to use the prime rate is "simply wrong" and remanded that issue to the Commission for further reconsideration. ¹⁹

MCI's speculation that a perverse incentive exists for the LECs is simply untrue. MCI suggested a scenario -- which is highly unlikely -- that when interest rates are low, LECs' inclusion of a higher return on long-term construction may actually discourage timely completion of the projects by allowing investment in the long-term plant as an alternative to short-

¹⁸ Communications Satellite Corporation, 56 F.C.C.2d 1101 (1975) ("Comsat").

¹⁹The Court remanded the issue of interest accrued during construction ("IDC") to the Commission, holding that it must first determine what was the most realistic borrowing assumption for Comsat. See Communications Satellite Corp. v. F.C.C., 611 F.2d 883, 896-97 (D.C. Cir. 1977). On remand, the Commission found that in Comsat's case, the IDC causes rate turbulence that might be avoided by the inclusion in Comsat's rate base the periodic payments as they are made to INTELSAT. Because of the rate base inclusion, the Commission did not make a specific, separate finding on its prime rate assumption regarding IDC. See Communications Satellite Corporation, 68 F.C.C.2d 941, 948-51 ¶ 25-32 (1978).

term plant; and that is detrimental to the infrastructure. MCI ignores the fact that accruing AFUDC based on the actual working capital has little or no bearing on the timely completion of a construction project. What is directly relevant is based on a variety of factors: customer demand, time of the year, available labor and material resources, just to name a few. These and other LEC operational decisions override purely economic decisions.

Lastly, MCI's suggestion that the filing of LEC waivers is procedurally better than rulemaking in the present context is inappropriate. AFUDC is a recurring financing issue. It requires the Commission to make a logical policy decision applicable to the entire LEC industry. To file individual waivers based on a rule that needs reform because it is anachronistic and does not truly reflect the LECs' current capital structure is cumbersome and time-consuming. Nor does it serve the public interest.

In sum, MCI's oppositions to the Ameritech proposal for a rulemaking to reexamine the AFUDC are without merit and should be denied.

III. THE COMMISSION SHOULD FIND THAT THE EQUITY COMPONENT OF AFUDC IS CONSISTENT WITH GAAP

²⁰MCI at 8.

NYNEX proposed that AFUDC be accrued in accordance with relevant GAAP principles.²¹ In particular, NYNEX states that the Commission should propose amendments to Part 32 and Part 65 that would require carriers to determine their AFUDC in accordance with the Statement of Financial Accounting Standards ("SFAS") No. 34.²²

USWC submits that the Commission should conduct a thorough and reasoned analysis to determine if GAAP principles apply in the present AFUDC context. Generally speaking, under GAAP, only long-term and short-term debt costs are considered. In SFAS No. 34, the Financial Accounting Standards Board ("Board") rejected a proposal to capitalize the equity component of interest costs because it could not agree on a method to determine the appropriate return on equity for non-regulated businesses. Paragraph 49 states as follows:

"...Some assenting Board members believe that it may be appropriate at some time in the future to consider whether the cost of equity capital should be recognized within a framework for financial reporting that continues to be based primarily on historical cost. Accordingly, they think that the standards prescribed in this Statement should not be incompatible with that possible development. Other assenting Board members do not share that view. Nevertheless, all Board members agreed that recognition of the cost of equity capital does not conform to the present accounting framework. In the present accounting framework, the cost of a resource is generally measured by the historical exchange price paid to acquire it. However, funds are an unusual kind of resource in that, although an enterprise obtains funds from various sources, only borrowed funds give rise to a cost that can be

²¹NYNEX at 2.

²²<u>Id</u>. at 4-5.

described as a historical exchange price. Although a historical exchange transaction may occur when equity securities are issued, that transaction is not the basis generally advocated for measuring the cost of equity capital. It is generally agreed that use of equity capital entails an economic cost, but in the absence of a historical exchange price, the cost of equity capital is not reliably determinable. The Board concluded, therefore, that the cost of financing expenditures for a qualifying asset should be measured by assigning to the asset an appropriate portion of the interest cost incurred on borrows during the period of its acquisition..."

No such concern for unreliability exists for the LECs' regulated business because the Commission prescribes the equity return for the LECs. Thus, it appears that the Board's reasoning for non-adoption of the equity cost as a component of working capital recovery does not apply in the regulated world and to entities like the LECs.

Additionally, the applicability of GAAP to the LEC industry is best explained by reference to SFAS No. 71,

equity component of AFUDC is compatible with GAAP. It is also a logical extention of GAAP.

IV. <u>CONCLUSION</u>

As the Court in <u>Illinois Bell</u> admonishes, LECs should file a petition for rulemaking if they wish the Commission to reconsider the rationale underlying its use of the prime rate for AFUDC. USWC supports Ameritech's petition and requests that the Commission initiate a rulemaking to resolve the appropriate means of accruing AFUDC for the LECs.

Respectfully submitted,

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April 5, 1991

²³Illinois Bell, 911 F.2d at 783.

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify on this 5th day of April, 1991, that I have caused a copy of the foregoing REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC. to be served via United States first class mail, postage prepaid, to the persons named on the attached service list.

Kelseau Powe, Jr.

^{*}Hand Delivered

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